

Internal Revenue Service
memorandum

CC:TL-N-281-90
Br2:JKHarris

date:

JAN 9 1990

to:

District Counsel, [REDACTED]
Attn: [REDACTED]

CC: [REDACTED]

from:

Assistant Chief Counsel (Tax Litigation)

CC:TL

subject:

[REDACTED]

This is in response to your request for tax litigation advice concerning the above-captioned case, which is not yet calendared, in which there are deficiencies for [REDACTED] and [REDACTED] in the amounts of \$[REDACTED] and \$[REDACTED], respectively. In addition, your office is presently reviewing a proposed notice of deficiency which determines liabilities for [REDACTED] and [REDACTED] on the same issue.

ISSUE

Whether a fish passage way facility required to be constructed as a part of a hydroelectric dam used by petitioner in its trade or business of producing electric power is eligible for investment credit pursuant to I.R.C. §§ 38 and 48.

FACTS

The petitioner is a [REDACTED] producer of electrical power in [REDACTED]. To generate electrical power, petitioner, and other power producers, operate a series of dams on the [REDACTED].

The specific dam at issue in this case spans the [REDACTED] at [REDACTED]. The function of the dam is twofold: (1) to provide a water supply for the production of electrical power and (2) to increase the height of the water ahead of hydraulic turbines, thereby increasing the quantity of electricity produced. The construction and operation of a dam for the production of electrical power prevents the migration of fish upriver to spawn and prevents young fish from swimming downriver to the sea. The dam at issue herein prevents the migration of [REDACTED] and [REDACTED].

Because petitioner's dam impacted the migration of fish in the [REDACTED], when petitioner was granted its initial license by the Federal Power Commission in [REDACTED], Article [REDACTED] of the license required petitioner to construct and maintain a fish

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passage way facility at the [REDACTED] dam pursuant to the requirements of the Secretary of the Interior. However, because other electric power companies operating on the [REDACTED] had not constructed fish passage ways, the Federal Power Commission did not actually require petitioner to construct its fish passage ways when the dam was constructed. When petitioner's original federal license expired in [REDACTED], the Federal Power Commission, at the request of the Secretary of the Interior, did require the construction of a fish passage way at [REDACTED] as a condition to granting petitioner a new license to operate.

After negotiation and consultation with various interested federal and state agencies, petitioner constructed and placed in service a fish passage way at its [REDACTED] dam in [REDACTED]. Petitioner claimed investment credit on the fish passage way in [REDACTED]. This issue is present in other tax years of petitioner because of carrybacks of investment credit and because substantially identical property was also placed in service in [REDACTED] at its dam in [REDACTED].

According to an Appeals Supporting Statement prepared in this case, petitioner's fish passage way facility not only functions to permit the migration of fish in the [REDACTED], it also enhances petitioner's operation of the dam for its principal purpose of producing hydroelectric power. That is, the fish passage way also functions as a spillway to pass river flows exceeding station capacity during the production of electric power. The fish passage way further functions to supply a portion of the minimum flow discharge required by petitioner's license to maintain downstream river flow levels for fish ecology purposes. The facility is also the subject of research concerning the effectiveness of such fish passage ways in general and to research the impact of the [REDACTED] Dam on the ecology of the [REDACTED]. Thus, the Appeals Supporting Statement concludes that the fish passage facility is employed by petitioner in its operation of the [REDACTED] dam to maximize the dam's overall efficiency in producing electrical power while minimizing the dam's operational impact on the ecology of the [REDACTED].

LAW AND DISCUSSION

For the years at issue, section 38 of the Code provided a credit against federal income tax for certain eligible property defined in section 48 that was placed in service by a taxpayer in the taxable year. Section 48(a)(1)(A) and (B) provided, in part, that eligible property was either "tangible personal property" or "other tangible property" but only if the such "other property" was used as an integral part of furnishing certain services, including electrical power.

In view of the nature of the property at issue in this case, there is no disagreement that the property is not tangible property because it is either a building or a permanent improvement to land. Therefore, to be eligible for investment credit, the fish passage way facility must qualify as other tangible property used as an integral part of furnishing electrical power.

Treas. Reg. § 1.48-1(d)(4) states that to be eligible for investment credit as an "integral part" for purposes of section 48(a)(1)(B), property must be used in one or more of the specified activities. Property is used as an integral part of an activity if it is used directly in the activity and is essential to the completeness of the activity.

Although there are no decided cases on the specific question at issue in this case, Revenue Ruling 73-466, 1973-2 C.B. 52, concludes that certain fish preservation property constructed in conjunction with a dam was not eligible for investment credit. The ruling states that while the fish preservation property is other tangible property, it is not eligible for investment credit because it is not essential to generating or furnishing electrical energy within the meaning of Treas. Reg. § 1.48-1(d)(4). The ruling states that the mandated construction of the facility by a federal agency does not make it an integral part of property furnishing electrical energy. This revenue ruling was relied on by the District Director in denying petitioner investment credit for its fish passage way property at the [REDACTED] Dam.

Under the facts of Rev. Rul. 73-466, there is no indication that the fish preservation property considered served any purpose other than to protect certain fish species in the waterway. In contrast, in the instant case, the facts demonstrate that petitioner does utilize the fish passage way facility in its overall hydroelectric power production process by using the fish passage way facility as a spillway for water in excess of that needed by the hydroelectric station.

Moreover, as pointed out by petitioner's counsel, the Service has published other revenue rulings that appear to be inconsistent with Rev. Rul. 73-466. For example, Rev. Rul. 81-120, 1981-1 C.B. 120, addressed the eligibility for investment credit of a water piping system, a waste-water collection tank and a deep well constructed and used by a chemical manufacturing company for waste removal. And Rev. Rul. 73-420, 1973-2 C.B. 9, addressed the eligibility for investment credit of tailings disposal dams constructed and used by a mining company to dispose of noxious waste materials. In each of these rulings, the Service concluded that the property was eligible for investment credit as property used directly in a qualifying activity -- manufacturing or mining -- and was essential to the completeness

of the qualifying activity. These revenue rulings reach this conclusion notwithstanding that the purpose of the property at issue was to protect the environment or public from the qualifying activity as opposed to serving as an operational element of the mining or manufacturing activity.

More importantly from a litigation point of view, the Tax Court has also held that property that protects the public from a qualifying activity is eligible for the credit as an integral part of that activity. In Spartanburg Terminal Co. v. Commissioner, 66 T.C. 916 (1976), nonacq. on this issue, 1977-1 C.B. 2, the property at issue was fencing installed around a railroad tunnel the petitioner had constructed through a heavily populated area to protect the public as well as to provide security for railroad property. The Tax Court concluded that the fencing was eligible for investment credit because public safety is an essential element in petitioner's operation the tunnel.¹

More recently, in a reviewed opinion in Southern Pacific Transportation Co. v. Commissioner, 90 T.C. 771 (1988), the Tax Court held that petitioner was entitled to claim investment credit on public highway overpasses constructed to carry vehicular traffic over its railroad tracks. The court specifically rejected respondent's arguments that the overpass property was not property used as an integral part of furnishing transportation. The court specifically stated that

(t)he fact that the public, and not Southern Pacific, actually travels on the overpasses does not diminish the benefit of the overpasses to Southern Pacific. Thus, we hold that Southern Pacific uses the overpasses to furnish transportation within the purview of section 48(a)(1).

90 T.C. at 787.

See also Vail Associates, Inc. v. Commissioner, 88 T.C. 1391 (1987), in which the Tax Court concluded that pipelines which transport and treat air and water used to manufacture snow are other tangible property under section 48(a)(1)(B) eligible for investment credit, notwithstanding that petitioner was not in the trade or business of manufacturing.

CONCLUSION

While Rev. Rul. 73-466 is the position of the Service, it is a narrowly written revenue ruling and we conclude that the facts of this case, discussed above, distinguish it from the facts of

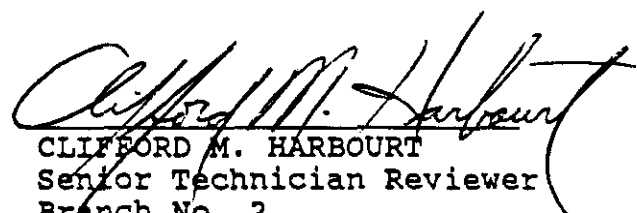
¹ As indicated, although the office issued a nonacquiescence on this issue in Spartanburg Terminal, there has been no subsequent litigation on the issue.

demonstrate that it utilizes the fish passage way facility as a spillway to aid in controlling the flow of water passing through its hydroelectric station during the production of electric power, as well as for ecological purposes, the petitioner can demonstrate that the fish passage way facility is factually an integral part of property used in the production of electrical power.

In addition, in concurrence with Appeals, we conclude that the government faces significant hazards in attempting to litigate this issue against petitioner. Because petitioner can factually distinguish Rev. Rul. 73-466, in light of the recent Tax Court cases cited herein that have taken an expansive view of the term "integral part" of property used in a qualifying activity within the meaning of section 48(a)(1), there is a strong likelihood that petitioner will prevail in the Tax Court.²

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² As stated in GCM 35377, [REDACTED] CC:I:I-4810, June 22, 1973, which was issued in connection with Rev. Rul. 73-466,

(t)he determination of whether something is integrally part of furnishing one of the specified activities seems to be a question to be decided on a given factual basis. . . . The facts of the given case do not show that the fish preservation [property] . . . [is] so closely combined with the operation to the hydroelectric plant as to be eligible for investment credit.

In contrast, as discussed herein, petitioner's "given factual basis" is such that it will be able to demonstrate to the Tax Court that the fish passage way facility is closely combined with its operation of its hydroelectric plant.